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# SUPREME COURT OF THE UNITED STATES.

**OCTOBER TERM, 1932.**

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## No. 448

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PETROLEUM EXPLORATION, PETITIONER,

*vs.*

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

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**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.**

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ROBERT ASH,
*Counsel for Petitioner.*

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Petroleum Exploration, by its attorney Robert Ash, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit in the above entitled case rendered October 3, 1932. The case is not yet reported in the reporter systems but is reported at ¶ 1850 of the Prentice-Hall 1932 Federal Tax Service. It is also printed in full as an appendix to the petition for a writ of certiorari in No. 434, *The United States* v. *Dakota-Montana Oil Company.*

## Question Presented.

Whether under the Revenue Act of 1926 the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through depreciation as contended by the petitioner or through depletion as contended by the Commissioner of Internal Revenue.

## Statute and Regulations Involved.

Revenue Act of 1926:

> "SEC. 234. (*a*) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * *
>
> "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;
>
> "(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"
>
> "SEC. 204(*c*)(2). In the case of oil and, gas wells the allowance for depletion shall be 27½

per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Treasury Regulations 69 provide:

"ART. 221. Depletion in the Case of Oil and Gas Wells.—Under Section 204(*c*)(2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(*c*)(2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges

these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *"

"ART. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercistd by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"

**Statement.**

The facts, which are fully stated at pages 30 to 32, inclusive, of the Record, are briefly summarized as follows:

During the years 1925, 1926 and 1927, Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid for drilling wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells. All the said wells had a life of more than one year.

Petroleum Exploration claimed that the entire cost of the wells, as stated above, was returnable to it through depreciation. The Commissioner of Internal Revenue held that the "intangible drilling costs," which include the amounts paid for drilling wells and the amounts paid for freight and haulage of the equipment and the amounts paid for labor in installing the equipment in the wells was not returnable through depreciation, but was recoverable through depletion. The Board of Tax Appeals decided in favor of Petroleum Exploration and adversely to the Commissioner of Internal Revenue. The Circuit Court of Appeals for the Fourth Circuit reversed the Board.

The taxpayer and the Commissioner are in agreement as to the formula to be applied in determining the amount of the deduction on account of the depreciation or depletion of this capital, whichever it is, and are in agreement as to the amount of the annual charge.

**Specifications of Error.**

1. The Circuit Court of Appeals erred in holding that the "intangible drilling costs" are returnable through depletion.

2. The Circuit Court of Appeals erred in not holding that the "intangible drilling costs" are returnable through depreciation.

3. The Circuit Court of Appeals erred in deciding in favor of the Commissioner of Internal Revenue.

**Reasons for Granting the Writ.**

1. In holding that "intangible drilling costs" are returnable through depletion instead of depreciation the decision below is in direct conflict with a recent decision of the Court of Claims. In *Dakota-Montana Oil Co.* v. *United States*, decided July 5, 1932, and reported in 59 Fed. (2d) 853, the Court of Claims held that under the Revenue Act of 1926 capitalized "intangible drilling costs" are not returnable by a depletion allowance and that they can only be returned through an allowance for depreciation. The opinion follows the Board of Tax Appeals in *A. T. Jergins Trust*, 22 B. T. A. 551, and is in direct conflict with the decision in the case at bar. The Government has filed a petition for certiorari in the *Dakota-Montana Oil Co.* case (No. 434), and cites as a basis for its petition the conflict with this case.

2. In the petition for certiorari in the *Dakota-Montana Oil Co.* case mentioned above the Government's brief states as a reason for its allowance the following:

> "2. The question presented is one of current general importance. The statutory provisions involved are in force in almost identical form in the 1928 and 1932 Revenue Acts. (Section

114(*b*)(3) of the Revenue Act of 1928; Section 114(*b*)(3) of the Revenue Act of 1932.) The question is presented in numerous cases now pending in the Bureau of Internal Revenue, the Board of Tax Appeals, and the Circuit Court of Appeals. The General Counsel of the Bureau of Internal Revenue states that it is present in cases before the Bureau involving claims for refund of approximately $5,000,000. The importance of the question from the taxpayer's point of view is that if expenses incurred in exploring and drilling oil and gas wells are subject to a depreciation allowance the taxpayer will normally receive the full amount of the expenses through such allowance, whereas due to the statutory limitation on the amount allowable for depletion the full amount of such expenses would not be returned through depletion. Thus the instant decision approves the taxpayer's deduction of the capitalized cost of drilling, in addition to the statutory depletion allowance of 27½ per centum of income. It is reasonable to suppose, therefore, that in all cases involving capitalized expenses arising out of the exploration and drilling of oil and gas wells taxpayers will claim that expenses such as those involved in this case are subject to a depreciation rather than a depletion allowance. The interpretation of these statutory provisions is, therefore, of importance to both taxpayers and to the Government. The existing conflict will make it impossible to administer the statutes with any certainty or consistency until the conflict is resolved by a decision of this Court."

**Conclusion.**

Wherefore it is respectfully submitted that this petition should be granted.

It is suggested that in the event the petition herein is granted that the case be advanced for argument and set immediately following No. 434, *The United States* v. *Dakota-Montana Oil Company.*

ROBERT ASH,
*Munsey Building,*
*Washington, D. C.,*
*Attorney for Petitioner.*

October, 1932.